PERSONAL FINANCE

A Kick in the Pocketbook on Child-Care Costs

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The Family Support Act of 1988 is going to reduce the government's support of a lot of families in which both parents work.

The measure, signed into law Thursday by President Reagan, is mainly concerned with overhauling the federal welfare system. But included in the measure are provisions that place new restrictions on the child-care tax benefits that have been available to two-earner families and single working parents.

The two benefits—the child-care tax credit and the employer-sponsored salary reduction plan—remain available. But the ability of parents to use the two together has been eliminated, and the age limits on the children covered have been tightened.

And parents who buy their day care in the underground economy will soon be forced to choose between lowering their own tax bill or that of their day-care provider.

Among the changes in the day-care provisions are these:

- Parents who claim either tax benefit will have to provide the Internal Revenue Service with the social security or tax identification number of the person or organization that provides the day care. (This does not apply to tax-exempt organizations such as churches.)

Effectively, that will mean that baby sitters will have to declare their fees as income on personal returns or run the risk of being tagged by the IRS computers.

- A child's care becomes ineligible for the tax benefits on his or her 13th birthday. The limit before had been 15. The cutoff is the child's age on the date the service was provided, so paying in advance doesn't work.
- Parents who have access to a salary reduction plan no longer will be able to take a tax credit on expenses that exceed the limit on the plan—a strategy known as piggy-backing.

While "from a tax perspective it's hard to quibble" with making people report the identity of their day-care providers, the other limits are "anomalous," said Bernard Schaeffer, a tax expert with Hay/Huggins, a benefits consulting firm based in Philadelphia. In Congress "they talk about the need for more day care and here they go making day care more expensive. There's some contradiction here."

The background is this. Congress allows two tax benefits for dependent care. The measures are used primarily for children but can be applied to disabled spouses or disabled adult dependents as well.

The first is the tax credit. It is equal to 20 to 30 percent of the expense, with the exact percentage depending on the family's income. The credit is available on expenses up to $2,400 for one child and $4,800 for two or more. Thus, it has a maximum value of $1,440 (30 percent of $4,800) for a couple or single parent at the lower end of the income scale.

The other allowable benefit goes by a number of names, such as salary reduction plan or dependent care spending account.

Under these plans, employees calculate their day-care costs at the beginning of the "plan year"—which may or may not match the calendar year—and arrange with their employers to have a portion of that amount withheld from their pay each period. In some cases employers make a contribution as well.

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The advantage is that this money—up to a limit of $5,000—is taken off the top before taxes are paid, and remains untaxed.

The disadvantage, however, is that if the employee miscalculates and the amount withheld exceeds the day-care expenses, the excess is forfeited at the end of the year. And an employee can change the withholding amount only under very limited circumstances.

Until now, it was possible for parents whose employers offered a salary reduction plan and who had expenses of more than $5,000 to use both benefits.

These parents could take the full $5,000 in salary reduction and then apply the tax credit to any additional qualifying expenses.

For example, said Janet Shepherd, a partner at the consulting firm of Hewitt Associates, a family with $6,000 in annual expenses could take the $5,000 salary reduction—worth $1,650 to a family in the 33 percent marginal bracket—and then apply the tax credit to the remaining $1,000, for an additional tax saving of $200 to $300.

Under the new law, however, any amounts taken under a salary reduction plan must be "offset" against the limit of the tax credit. Thus, in Shepherd's example, the $5,000 taken under the salary reduction plan would reduce the maximum allowable expense under the tax credit to zero.

The new legislation may also hang some parents out to dry next year by disallowing some of the expenses they expected to claim. The new provisions take effect Jan. 1, but many employers' plans do not follow calendar years.

Thus, the parents of a 14-year-old might find unexpectedly that their expenses no longer qualify, but they cannot stop contributing until the end of the employer's plan year several months later. Unless they had other qualifying expenses, that money simply would be lost.

"People in the middle of their plan year, who made elections [of withholding] last summer, may feel that the rug has been jerked out from under them," said Shepherd.

It's important that employees realize quickly what has been done, said Deborah Hrouda of the Washington office of TFP&C, another benefits consulting firm. "It's possible that some have already signed up for [salary reduction] next year and now may not benefit or may not want to participate becuase of the reporting rule." Employees in this situation should talk to their benefits office at once, she said.

The impact of the tax reporting requirement is hard to gauge, but there was wide agreement that it will be significant. Parents will be required to include on their tax returns the name and address as well as ID number.

Failure to do so will result in loss of the tax benefit, and supplying incorrect information will have the same effect unless the parent can show he or she exercised "due diligence" in trying to get correct information.

"Congress has a legitimate purpose here. Day care providers are not reporting the income," said Schaeffer of Hay/Huggins. "But it's going to raise the cost of day care."

The provision is likely to strike hardest at parents who use informal arrangements, such as paying a friend or neighbor to keep the kids for a few hours each day, and at those who employ illegal aliens, several benefits experts said. These parents will be forced to choose between their current arrangements and the tax benefits.